

**Department of the Treasury**  
**Tennessee Consolidated Retirement System**

**For the Year Ended**  
**June 30, 1998**

***Arthur A. Hayes, Jr., CPA***

Director

***Barbara K. White, CPA***

Assistant Director

***Edward Burr, CPA***

Audit Manager

***Derek D. Martin, CPA***

In-Charge Auditor

***Bridget Carver***

***Jonathan B. Green***

***Ronald H. Queen***

***Randy A. Salt***

***Melissa Thacker***

Staff Auditors

***Erica V. Smith, CPA***

Technical Analyst

***Jane Russ***

Editor

February 26, 1999

Members of the General Assembly  
and  
The Honorable Steve Adams, Treasurer  
and  
Members of the Board  
Tennessee Consolidated Retirement System  
State Capitol  
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Consolidated Retirement System for the year ended June 30, 1998. You will note from the independent auditor's report that a qualified opinion was given on the fairness of the presentation of the financial statements. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter.

Consideration of internal control over financial reporting and tests of compliance resulted in no audit findings.

Sincerely,

John G. Morgan  
Comptroller of the Treasury

JGM/ms  
98/100

State of Tennessee

# Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit  
**Tennessee Consolidated Retirement System**  
For the Year Ended June 30, 1998

---

## AUDIT OBJECTIVES

The objectives of the audit were to consider the system's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, and contracts, to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

## AUDIT FINDINGS

The audit report contains no findings.

## OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is qualified. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter.

---

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

Comptroller of the Treasury, Division of State Audit  
1500 James K. Polk Building, Nashville, TN 37243-0264  
(615) 741-3697

---

**Audit Report**  
**Department of the Treasury**  
**Tennessee Consolidated Retirement System**  
**For the Year Ended June 30, 1998**

---

**TABLE OF CONTENTS**

---

	<u>Exhibit</u>	<u>Page</u>
<b>INTRODUCTION</b>		1
Post-Audit Authority		1
Legislative History		1
Organization		2
<b>AUDIT SCOPE</b>		2
<b>OBJECTIVES OF THE AUDIT</b>		4
<b>PRIOR AUDIT FINDINGS</b>		4
<b>RESULTS OF THE AUDIT</b>		4
Audit Conclusions		4
Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i>		6
<b>FINANCIAL STATEMENTS</b>		
Independent Auditor's Report		8
Statement of Plan Net Assets	A	10
Statement of Changes in Plan Net Assets	B	12
Notes to the Financial Statements		14

---

## TABLE OF CONTENTS (CONT.)

---

	<u>Exhibit</u>	<u>Page</u>
<b>REQUIRED SUPPLEMENTARY INFORMATION</b>		
Schedule of Funding Progress	C	24
Schedules of Employer Contributions	D	26
Notes to Required Supplementary Information		27

**Department of the Treasury  
Tennessee Consolidated Retirement System  
For the Year Ended June 30, 1998**

---

**INTRODUCTION**

---

**POST-AUDIT AUTHORITY**

This is a report on the financial and compliance audit of the Tennessee Consolidated Retirement System. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

**LEGISLATIVE HISTORY**

The Tennessee Consolidated Retirement System (TCRS) was established in 1972 by an act of the Tennessee General Assembly. Seven existing retirement systems were consolidated to provide retirement, disability, and death benefits to state employees, public school teachers, higher education employees, and employees of participating local governments. State laws govern the retirement plan, and amendments to the plan can only be made by legislation enacted by the General Assembly of the State of Tennessee.

An 18-member Board of Trustees has the responsibility to manage and oversee the operation of the consolidated system. The board consists of nine *ex officio* members from the executive, legislative, and judicial branches of state government, eight representatives of the active TCRS membership, and one representative of retirees. TCRS is administered by the Department of the Treasury under the legislative branch of state government. By state law, the State Treasurer serves as Chairman of the Board of Trustees and as custodian of the funds of the system.

Membership in the retirement system is a condition of employment for full-time state employees, K-12 teachers, higher education general employees, and employees of participating local governments. Membership is optional for part-time state employees and part-time employees of political subdivisions which have authorized such coverage. Interim teachers and part-time teachers have optional membership. Faculty and certain other employees of institutions of higher education may elect participation in either TCRS or an optional retirement program. TCRS

membership has grown steadily since 1972 when there were approximately 93,000 members. As of June 30, 1998, there were 184,194 active members and 68,944 retirees.

## **ORGANIZATION**

The Tennessee Consolidated Retirement System is organized into three major service areas: Counseling Services, Financial Services, and Member Services.

Counseling Services is responsible for pre-retirement counseling of members on their potential benefit payments under different options. The section also processes claims for disability retirement and provides field support, including new employer coverage.

Financial Services processes refunds to terminated members, administers the retired payroll, distributes the pension payments, and coordinates actuarial valuations.

Member Services processes membership forms received from all state agencies, local boards of education, and participating political subdivisions. Prior service specialists assist in establishing prior service credit for eligible members or former members who have requested such credit. Benefit calculation specialists compute new retiree benefits based on the option chosen. The section is also responsible for researching, controlling, and correcting member records on the Treasury Retirement Accounting and Control System.

An organization chart for the Tennessee Consolidated Retirement System is on the following page.

---

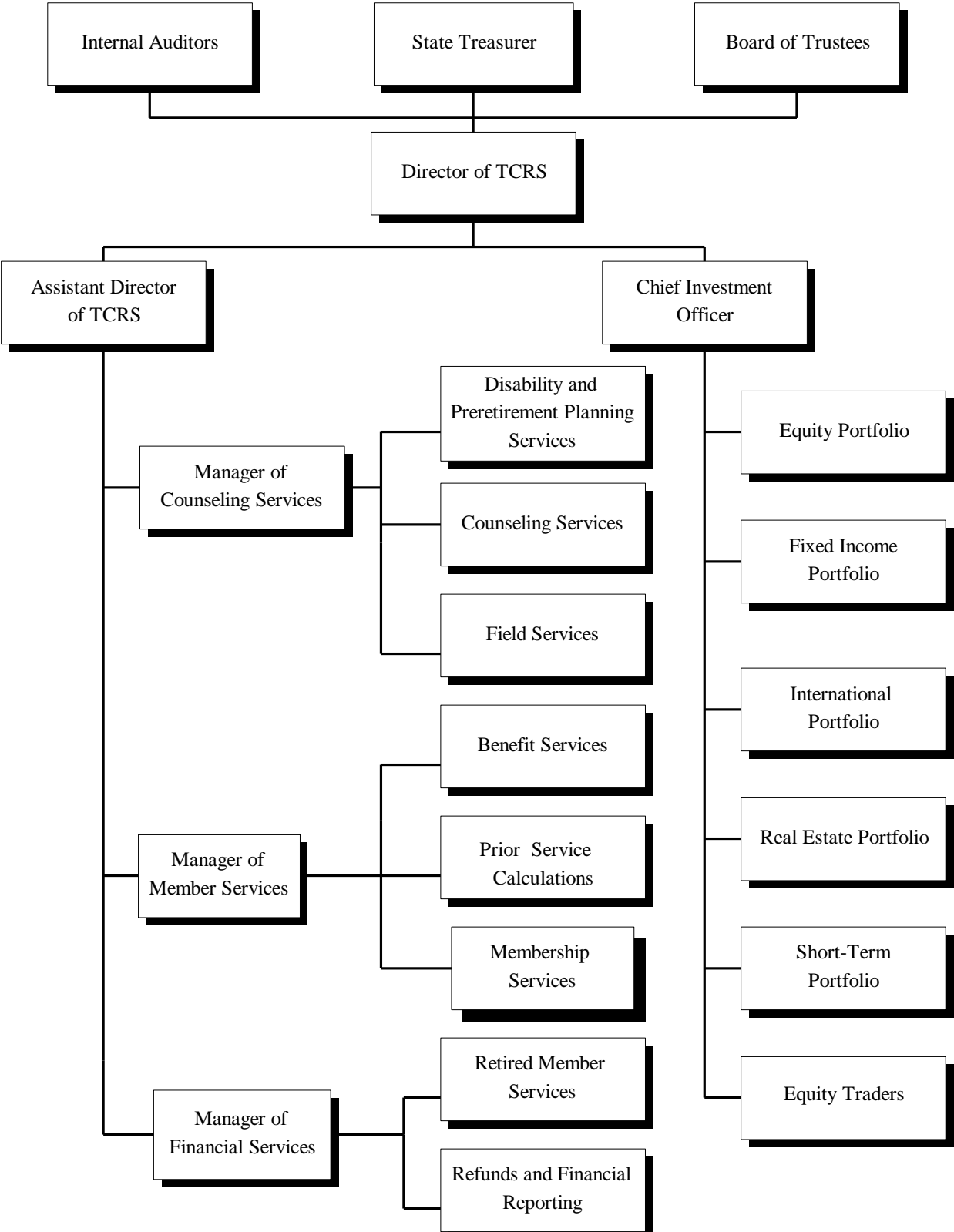
## **AUDIT SCOPE**

---

The audit was limited to the period July 1, 1997, through June 30, 1998, and was conducted in accordance with generally accepted government auditing standards except as indicated in the Independent Auditor's Report. Financial statements are presented for the years ended June 30, 1998, and June 30, 1997. The Tennessee Consolidated Retirement System forms an integral part of state government and as such has been included as a pension trust fund in the Tennessee Comprehensive Annual Financial Report.



**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM  
ORGANIZATION CHART**



---

## OBJECTIVES OF THE AUDIT

---

The objectives of the audit were

1. to consider the Tennessee Consolidated Retirement System's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, and contracts;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

---

## PRIOR AUDIT FINDINGS

---

There were no findings in the prior audit report.

---

## RESULTS OF THE AUDIT

---

### AUDIT CONCLUSIONS

#### Internal Control

As part of the audit of the Tennessee Consolidated Retirement System's financial statements for the year ended June 30, 1998, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by generally accepted government auditing standards. Consideration of internal control disclosed no material weaknesses.

#### Compliance

The results of our audit tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

### Fairness of Financial Statement Presentation

The Division of State Audit has rendered a qualified opinion on the financial statements of the Tennessee Consolidated Retirement System. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Tennessee Consolidated Retirement System's disclosures with respect to the year 2000 issue made in Note D.2.

**Report on Compliance and on Internal Control Over Financial Reporting  
Based on an Audit of the Financial Statements  
Performed in Accordance With *Government Auditing Standards***

December 29, 1998

The Honorable W. R. Snodgrass  
Comptroller of the Treasury  
State Capitol  
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have audited the financial statements of the Tennessee Consolidated Retirement System, as of and for the year ended June 30, 1998, and have issued our report thereon dated December 29, 1998. Our report was qualified. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Tennessee Consolidated Retirement System's disclosures with respect to the year 2000 issue made in Note D.2.

Except as discussed in the preceding paragraph, we conducted our audit in accordance with generally accepted government auditing standards.

Compliance

As part of obtaining reasonable assurance about whether the system's financial statements are free of material misstatement, we performed tests of the system's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

The Honorable W. R. Snodgrass  
December 29, 1998  
Page Two

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the system's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

However, we noted certain matters involving the internal control over financial reporting that we have reported to the system's management in a separate letter.

This report is intended for the information of the General Assembly of the State of Tennessee and management. However, this report is a matter of public record, and its distribution is not limited.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director  
Division of State Audit

AAH/ms

## **Independent Auditor's Report**

December 29, 1998

The Honorable W. R. Snodgrass  
Comptroller of the Treasury  
State Capitol  
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have audited the accompanying statements of plan net assets of the Tennessee Consolidated Retirement System, as of June 30, 1998, and June 30, 1997, and the related statements of changes in plan net assets for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. The Tennessee Consolidated Retirement System has included such disclosures in Note D.2. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Tennessee Consolidated Retirement System's

The Honorable W. R. Snodgrass  
December 29, 1998  
Page Two

disclosures with respect to the year 2000 issue made in Note D.2. Further, we do not provide assurance that the Tennessee Consolidated Retirement System is or will be year 2000 ready, that the Tennessee Consolidated Retirement System's year 2000 remediation efforts will be whole or in part, or that the parties with which the Tennessee Consolidated Retirement System successful in does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the Tennessee Consolidated Retirement System as of June 30, 1998, and June 30, 1997, and the results of its operations for the years then ended in conformity with generally accepted accounting principles.

The schedules of funding progress and employer contributions on pages 24 and 26, respectively are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 29, 1998, on our consideration of the system's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director  
Division of State Audit

AAH/ms

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**COMPARATIVE STATEMENTS OF PLAN NET ASSETS**  
**AS OF JUNE 30, 1998, AND JUNE 30, 1997**

**Exhibit A**

*Expressed in Thousands*

	State Employees, Teachers, Higher Ed. Employees Pension Plan (SETHEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 1998 Total	State Employees, Teachers, Higher Ed. Employees Pension Plan (SETHEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 1997 Total
<b>ASSETS:</b>						
Cash	\$ 23,097	\$ 234	\$ 23,331	\$ 59,917	\$ 7,382	\$ 67,299
Receivables:						
Member Contributions Receivable	12,681	2,596	15,277	11,557	2,312	13,869
Employer Contributions Receivable	13,491	4,899	18,390	21,508	4,335	25,843
Accrued Interest Receivable	140,343	20,395	160,738	137,622	19,555	157,177
Accrued Dividends Receivable	8,442	1,227	9,669	8,926	1,268	10,194
Other Investment Receivable	927	135	1,062	3,177	451	3,628
Investments Sold	26,631	3,870	30,501	33,521	4,763	38,284
Total Receivables	202,515	33,122	235,637	216,311	32,684	248,995
Investments, at fair value:						
Short-term Securities	802,397	116,608	919,005	766,362	108,890	875,252
Domestic Securities:						
Government Bonds	6,426,129	933,874	7,360,003	4,807,877	683,139	5,491,016
Corporate Bonds	2,697,109	391,956	3,089,065	2,967,717	421,676	3,389,393
Corporate Stocks	5,655,385	821,866	6,477,251	4,850,437	689,187	5,539,624
International Securities:						
Government Bonds	1,176,324	170,949	1,347,273	1,065,051	151,330	1,216,381
Corporate Bonds	188,826	27,442	216,268	283,619	40,299	323,918
Corporate Stocks	1,264,607	183,778	1,448,385	1,331,653	189,211	1,520,864
Total Investments	18,210,777	2,646,473	20,857,250	16,072,716	2,283,732	18,356,448
Invested Securities Lending Collateral	0	0	0	306,399	43,536	349,935
<b>TOTAL ASSETS</b>	<b>18,436,389</b>	<b>2,679,829</b>	<b>21,116,218</b>	<b>16,655,343</b>	<b>2,367,334</b>	<b>19,022,677</b>
<b>LIABILITIES:</b>						
Retired Payroll Payable	12,463	1,778	14,241	13,225	1,890	15,115
Warrants Payable	408	298	706	209	226	435
Accounts Payable:						
Death Benefits and Refunds Payable	789	428	1,217	1,173	778	1,951
Other	54	58	112	16	1	17
Investments Purchased	35,760	5,197	40,957	117,031	16,629	133,660
Other Investment Payables	1,308	190	1,498	1,946	277	2,223
Securities Lending Collateral	0	0	0	306,400	43,535	349,935
<b>TOTAL LIABILITIES</b>	<b>50,782</b>	<b>7,949</b>	<b>58,731</b>	<b>440,000</b>	<b>63,336</b>	<b>503,336</b>
<b>NET ASSETS HELD IN TRUST FOR PENSION</b>						
BENEFITS (Schedule of Funding Progress for the PSPP Plan is presented on page 24)	\$ 18,385,607	\$ 2,671,880	\$ 21,057,487	\$ 16,215,343	\$ 2,303,998	\$ 18,519,341



**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**COMPARATIVE STATEMENTS OF CHANGES IN PLAN NET ASSETS**  
**FOR THE YEARS ENDED JUNE 30, 1998, AND JUNE 30, 1997**

**Exhibit B**

<i>Expressed in Thousands</i>	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	For the Year Ended June 30, 1998 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	For the Year Ended June 30, 1997 Total
<b>ADDITIONS</b>						
Contributions:						
Member contributions	\$ 116,196	\$ 39,086	\$ 155,282	\$ 110,697	\$ 32,959	\$ 143,656
Employer contributions	166,756	65,276	232,032	278,417	59,167	337,584
Total contributions	<u>282,952</u>	<u>104,362</u>	<u>387,314</u>	<u>389,114</u>	<u>92,126</u>	<u>481,240</u>
Investment income:						
Net appreciation in fair value of investments	1,655,047	239,084	1,894,131	1,499,296	212,126	1,711,422
Interest	655,178	94,644	749,822	596,369	84,368	680,737
Dividends	108,996	15,745	124,741	110,218	15,593	125,811
Total investment income	<u>2,419,221</u>	<u>349,473</u>	<u>2,768,694</u>	<u>2,205,883</u>	<u>312,087</u>	<u>2,517,970</u>
Less: Investment expense	9,332	1,350	10,682	7,632	1,088	8,720
Net income from investing activities	<u>2,409,889</u>	<u>348,123</u>	<u>2,758,012</u>	<u>2,198,251</u>	<u>310,999</u>	<u>2,509,250</u>
Securities lending activities:						
Securities lending income	2,080	301	2,381	76,749	10,858	87,607
Less: Securities lending expense	1,857	268	2,125	71,753	10,151	81,904
Net income from securities lending activities	<u>223</u>	<u>33</u>	<u>256</u>	<u>4,996</u>	<u>707</u>	<u>5,703</u>
Net investment income	<u>2,410,112</u>	<u>348,156</u>	<u>2,758,268</u>	<u>2,203,247</u>	<u>311,706</u>	<u>2,514,953</u>
TOTAL ADDITIONS	<u>2,693,064</u>	<u>452,518</u>	<u>3,145,582</u>	<u>2,592,361</u>	<u>403,832</u>	<u>2,996,193</u>
<b>DEDUCTIONS</b>						
Annuity benefits:						
Retirement benefits	378,485	53,991	432,476	346,192	49,478	395,670
Survivor benefits	24,127	3,441	27,568	21,829	3,120	24,949
Disability benefits	12,694	1,811	14,505	11,578	1,655	13,233
Cost of living	88,435	12,615	101,050	73,751	10,540	84,291
Death benefits	2,557	746	3,303	2,395	801	3,196
Refunds	14,311	10,338	24,649	11,444	12,389	23,833
Administrative expense	2,191	1,694	3,885	2,221	1,636	3,857
TOTAL DEDUCTIONS	<u>522,800</u>	<u>84,636</u>	<u>607,436</u>	<u>469,410</u>	<u>79,619</u>	<u>549,029</u>
NET INCREASE	2,170,264	367,882	2,538,146	2,122,951	324,213	2,447,164
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS						
BEGINNING OF YEAR	16,215,343	2,303,998	18,519,341	14,092,392	1,979,785	16,072,177
END OF YEAR	<u>\$ 18,385,607</u>	<u>\$ 2,671,880</u>	<u>\$ 21,057,487</u>	<u>\$ 16,215,343</u>	<u>\$ 2,303,998</u>	<u>\$ 18,519,341</u>

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 1998, AND JUNE 30, 1997**

---

The Tennessee Consolidated Retirement System (TCRS) administers two defined benefit pension plans—State Employees, Teachers and Higher Education Employees Pension Plan (SETHEEPP) and Political Subdivisions Pension Plan (PSPP). Although the assets of the plans are commingled for investment purposes, each plan's assets may be used only for the payment of benefits to members of that plan, in accordance with the terms of the plan.

**A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

- 1. Reporting Entity**—The TCRS is included in the State of Tennessee Financial Reporting Entity. Because of the state's fiduciary responsibility, the TCRS has been included as a pension trust fund in the *Tennessee Comprehensive Annual Financial Report*.
- 2. Measurement Focus and Basis of Accounting**—The accompanying financial statements have been prepared in conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB). The TCRS follows all applicable GASB pronouncements, as well as applicable private-sector pronouncements issued on or before November 30, 1989. The financial statements have been prepared using the economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Plan member contributions are recognized in the period in which the contributions are due. Plan employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan.

**Cash**—Cash and cash equivalents, by definition, includes cash and short-term investments with a maturity date within three months of the acquisition date. The state's accounting policy regarding the definition of cash and cash equivalents includes cash management pools as cash. In addition, under the policy, short-term securities otherwise defined as cash equivalents, that are in portfolios where the primary purpose is to facilitate the placement of funds in long-term investments, are classified as investments.

Cash received by the TCRS that cannot be invested immediately in securities is invested in the Pooled Investment Fund administered by the State Treasurer. The Pooled Investment Fund is authorized by state statute to invest funds in accordance with policy guidelines approved by the Funding Board of the State of Tennessee. The current resolution of that board gives the Treasurer authority to invest in collateralized certificates of deposit in authorized state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements, various U.S. Treasury and Agency obligations, and obligations of the state of Tennessee pursuant to *Tennessee Code Annotated, Section 9-4-602(b)*. The Pooled Investment

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS (CONT.)**  
**JUNE 30, 1998, AND JUNE 30, 1997**

---

Fund is also authorized to enter into securities lending agreements in which U.S. Government securities may be loaned to brokers for a fee. The loaned securities are transferred to the borrower by the custodial agent upon simultaneous receipt of collateral securities. The pool's custodial credit risk is presented in the *Tennessee Comprehensive Annual Financial Report* for the years ended June 30, 1998, and June 30, 1997. The classification of Cash also includes cash held in a custody account under a contractual arrangement for master custody services. Cash balances with the custodial agent are not classified into the credit risk categories established by Statement Number 3 of the Governmental Accounting Standards Board as the custody account relationship does not meet the definition for either a deposit with a financial institution or a security.

- 4. Method Used to Value Investments**—Investments are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Investments that do not have an established market are reported at estimated fair values. Investment income consists of realized and unrealized appreciation (depreciation) in the fair value of investments. Interest income is recognized when earned. Securities and securities transactions are recorded in the financial statements on trade-date basis.
- 5. Receivables**—Receivables primarily consist of interest which is recorded when earned. The receivables for contributions as of June 30, 1998, consist of \$26.2 million due from other funds within the state and \$7.5 million due from other governments. The receivables for contributions as of June 30, 1997, consist of \$33.0 million due from other funds within the state and \$6.6 million due from other governments.
- 6. Reclassification**—Foreign currency in the amount of \$39,924,683, classified as International Corporate Stocks on the June 30, 1997 Statement of Plan Net Assets has been reclassified as cash.

**B. PLAN DESCRIPTIONS AND CONTRIBUTION INFORMATION**

At June 30, 1997, the date of the latest actuarial valuation, the membership of each plan consisted of the following:

	SETHEEPP	PSPP
Retirees and beneficiaries currently receiving benefits	48,834	17,828
Terminated members entitled to but not receiving benefits	10,681	2,393
Current active members	<u>120,515</u>	<u>58,656</u>
Total	180,030	78,877
Number of participating employers	142	365

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS (CONT.)**  
**JUNE 30, 1998, AND JUNE 30, 1997**

---

**State Employees, Teachers and Higher Education Employees Pension Plan**

*Plan Description* - SETHEEPP is a cost-sharing, multiple employer defined benefit pension plan that covers the employees of the state, teachers with local education agencies (LEA's) and higher education employees. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan on or after July 1, 1979, are vested after five years of service. Members joining prior to July 1, 1979, are vested after four years of service. Cost of living adjustments (COLA) are provided each July based on the percentage change in the Consumer Price Index (CPI) during the previous calendar year. No COLA is granted if the CPI increases less than one percent. The maximum annual COLA is capped at three percent. Benefit provisions are established by state statute found in Title Eight, Chapters 34 through 37 of the *Tennessee Code Annotated*. State statutes are amended by the Tennessee General Assembly.

*Superseded Systems and Certain Employment Classifications*—Members of superseded systems that became members of the TCRS at consolidation in 1972 have their rights preserved to the benefits of the superseded system, if the benefit from the superseded plan exceeds that provided by the Group 1 (teachers and general employees) TCRS formula. Likewise, public safety employees and officials of TCRS Groups 2, 3 and 4 are entitled to the benefits of those formulas, if better than the Group 1 benefits.

*Contributions and Reserves*—Effective July 1, 1981, the plan became noncontributory for most state and higher education employees. The contribution rate for teachers is five percent of gross salary. The employers contribute a set percentage of their payrolls, determined by an actuarial valuation. *Tennessee Code Annotated*, Title Eight, Chapter 37, provides that the contribution rates be established and may be amended by the Board of Trustees of the TCRS. The administrative budget for the plan is approved through the state of Tennessee's annual budget process. Funding for the administrative budget is included in employer contributions.

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 1998, the plan's Member Reserve and Employer Reserve were

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS (CONT.)**  
**JUNE 30, 1998, AND JUNE 30, 1997**

---

fully funded with balances of \$2,268.7 million and \$16,116.9 million, respectively. At June 30, 1997, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$2,141.0 million and \$14,074.3 million, respectively.

**Political Subdivisions Pension Plan**

*Plan Description*—PSPP is an agent multiple-employer defined benefit pension plan that covers the employees of participating political subdivisions of the state of Tennessee. Employee class differentiations are not made under PSPP. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan prior to July 1, 1979, are vested after four years of service. Members joining on or after July 1, 1979, are vested upon completion of 10 years of service, unless five years vesting is authorized by resolution of the chief governing body. Cost of living adjustments, if adopted by a political subdivision, are provided each July based on the percentage change in the Consumer Price Index (CPI) during the previous calendar year. No COLA is granted if the CPI increases less than one percent. The maximum annual COLA is capped at three percent. Benefit provisions are established and amended by state statute. Pursuant to Article Two, Section 24 of the *Constitution of the State of Tennessee*, the state cannot mandate costs on local governments. Any benefit improvement may be adopted by the governing body of a governmental entity participating in the TCRS.

*Contributions and Reserves*—Political subdivisions may elect contributory or noncontributory retirement for their employees. The contribution rate for contributory employees of political subdivisions is five percent of gross salary. The employers contribute a set percentage of their payrolls, equal to at least, the percentage determined by an actuarial valuation. State statute provides that the contribution rates be established and may be amended by the Board of Trustees of the TCRS. The administrative budget for the plan is approved through the state's annual budget process. Funding for the administrative budget is included in employer contributions.

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 1998, the plan's Member Reserve and Employer Reserve were

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS (CONT.)**  
**JUNE 30, 1998, AND JUNE 30, 1997**

---

fully funded with balances of \$467.6 million and \$2,204.3 million, respectively. At June 30, 1997, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$425.7 million and \$1,878.3 million, respectively.

**C. INVESTMENTS**

State statute authorizes the TCRS to invest in bonds, debentures, preferred stock and common stock, real estate, and other good and solvent securities subject to the approval of the Board of Trustees and further subject to the following restrictions:

- a. The total sum invested in common and preferred stocks shall not exceed seventy-five percent (75%) of the total of the funds of the retirement system.
- b. The total sum invested in notes and bonds or other fixed income securities exceeding one year in maturity shall not exceed seventy-five percent (75%) of the total funds of the retirement system. Private Placements are limited to 15% of the total fixed income portfolio.
- c. Within the restrictions in (a) and (b) above, an amount not to exceed fifteen percent (15%) of the total of the funds of the retirement system may be invested in securities of the same kinds, classes, and investment grades as those otherwise eligible for investment in various approved foreign countries.
- d. The total amount of securities loaned under a securities lending program cannot exceed thirty percent (30%) of total assets.
- e. The total sum invested in real estate shall not exceed five percent (5%) of the total of the funds of the retirement system.

The TCRS maintains a portfolio of short-term investments in order to actively manage all funds waiting to be placed in a more permanent investment. These short-term investments may include U.S. Treasury obligations, commercial paper, medium-term corporate notes, promissory notes and repurchase agreements.

The TCRS investment securities are categorized on the chart that follows according to the level of custodial credit risk associated with the custodial arrangements. Category 1 includes investments that are insured or registered, or for which the securities are held by the TCRS or its agent in the name of the TCRS. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the name of the TCRS. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by the counterparty's trust department or agent, but not in the name of the TCRS.

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 1998, AND JUNE 30, 1997 (CONT.)**

<i>Expressed in Thousands</i>	<u>Fair Value June 30, 1998</u>	<u>Fair Value June 30, 1997</u>
<u>Investments - Category 1</u>		
Short-term Securities		
Commercial Paper	\$ 730,938	\$ 749,460
Medium-term Corporate Notes	31,584	-
U. S. Government Securities	156,483	125,792
Long-term Investments		
Domestic Securities		
Government Bonds	7,354,911	5,443,664
Corporate Bonds	3,089,065	3,296,759
Corporate Stocks	6,465,187	5,458,081
International Securities		
Government Bonds	1,347,273	1,195,959
Corporate Bonds	216,268	323,918
Corporate Stocks	1,412,509	1,279,831
<u>Total Investments - Category 1</u>	<u>20,804,218</u>	<u>17,873,464</u>
<u>Investments - Category 2</u>	<u>-</u>	<u>-</u>
<u>Investments - Category 3</u>		
Short-term securities lending collateral investments held by custodian bank	-	349,935
Margin Deposit on Futures Contracts		
Domestic Government Bonds	5,092	19,036
<u>Total Investments - Category 3</u>	<u>5,092</u>	<u>368,971</u>
<u>Investments - Not Categorized</u>		
Investments held by broker-dealers under securities on loan contracts for cash collateral		
Domestic Securities		
Corporate Bonds	-	78,986
Corporate Stocks	-	63,265
International Securities		
Corporate Stocks	-	192,304
Unsettled Investment Acquisitions		
Domestic Securities		
Government Bonds	-	28,316
Corporate Bonds	-	13,648
Corporate Stocks	12,064	18,278
International Securities		
Government Bonds	-	20,422
Corporate Stocks	35,876	48,729
<u>Total Investments - Not Categorized</u>	<u>47,940</u>	<u>463,948</u>
<u>Total Investments and invested securities lending collateral</u>	<u>\$ 20,857,250</u>	<u>\$ 18,706,383</u>

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS (CONT.)**  
**JUNE 30, 1998, AND JUNE 30, 1997**

---

As of June 30, 1998, and June 30, 1997, the TCRS had no concentrations of investments, other than those issued or guaranteed by the U.S. government, in any one organization that represents five percent or more of plan net assets.

*Securities Lending*—The TCRS is authorized by its investment policy, as adopted by the Board of Trustees, to enter into collateralized securities lending agreements whereby the TCRS loans its debt and equity securities for a fee to a select few of the highest quality securities firms and banks. Loans must be limited so the total amount on loan does not exceed 30 percent of the TCRS' assets. The TCRS' custodian bank manages the lending program and maintains the collateral on behalf of the TCRS. The borrower may deliver collateral to the lending agent in the form of cash or bonds, notes, and treasury bills of the United States or other obligations guaranteed as to principal and interest by the United States or any of its agencies or by the Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, Student Loan Marketing Association and other United States government sponsored corporations or enterprises. Cash received as collateral may be reinvested by the lending agent in accordance with the investment policy, as further restricted under the TCRS securities lending agreement. Collateral securities cannot be pledged or sold unless the borrower defaults.

The loaned securities are initially collateralized at 102 percent of their fair value for domestic securities and 105 percent for international. Collateral is marked-to-market daily and additional collateral is pledged by the borrower if the fair value of the collateral subsequently falls below 100 percent for domestic securities and 105 percent for international. Although there is no specific policy for matching the maturities of collateral investments and the securities loans, the securities on loan can be terminated on demand by either the TCRS or the borrower. As of June 30, 1998, the TCRS had no securities on loan. The TCRS securities lending income, net of expenses, was \$255,740.83 for the year ended June 30, 1998, and \$5,703,225 for the year ended June 30, 1997. At June 30, 1997, substantially all cash collateral was invested in overnight or on-demand investments with a weighted average term to maturity of four days. As of June 30, 1997, the fair value of securities on loan to brokers was \$334,555,819, and the fair value of collateral pledged for the securities on loan was \$349,934,991. At June 30, 1997, the TCRS had no credit risk exposure to borrowers because the amounts the TCRS owed the borrowers exceeded the amounts the borrowers owed the TCRS.

*Financial Instruments with Off-Balance Sheet Risk*

The TCRS is a party to financial instruments with off-balance sheet risk used in the normal course of business to generate earnings and reduce its own exposure to fluctuations in market conditions.



---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS (CONT.)**  
**JUNE 30, 1998, AND JUNE 30, 1997**

---

The TCRS is authorized by statute to engage in forward contracts to exchange different currencies at a specified future date and rate and in domestic stock index futures contracts. These contracts involve elements of custodial credit, market and legal risk in excess of amounts recognized in the Statement of Plan Net Assets as of June 30, 1998, and June 30, 1997. The TCRS may purchase or sell domestic stock index futures contracts for the purposes of making asset allocation changes and improving liquidity. Futures contracts are limited to the S&P 500 Index, the S&P Midcap 400 Index and the Russell 2000 Index. The contractual or notional amounts express the extent of the TCRS' involvement in these instruments and do not represent exposure to credit loss. The credit risk on forward and futures contracts is controlled through limits and monitoring procedures. Market risk, the risk that changing market conditions may make a financial instrument less valuable, is controlled through limitations on the use of such instruments. Legal risk is controlled through the use of only authorized instruments and brokers.

The allowable currencies for hedging purposes are limited by policy of the Board of Trustees to the currencies of those countries otherwise authorized for investment. At June 30, 1998, there were forward exchange contracts outstanding at a total net notional amount of \$528,898,678 and a fair value of \$524,041,284. At June 30, 1997, there were forward exchange contracts outstanding at a total net notional amount of \$310,259,951 and a fair value of \$315,161,569.

At June 30, 1998, the notional amount of futures contracts was \$138,731,250 at a fair value of \$142,875,000. At June 30, 1997, the notional amount of futures contracts was \$426,325,000 at a fair value of \$445,125,000. The changes in fair value of outstanding futures contracts are settled daily.

The TCRS is also authorized by investment policy to engage in the issuance of options. Activity is limited to selling covered call options. The TCRS had no options outstanding at June 30, 1998, and June 30, 1997.

**D. COMMITMENTS**

- 1. Standby Note Purchase Agreement**—The TCRS has agreed to serve as standby note purchaser for notes issued by the Funding Board of the State of Tennessee. By serving as a standby note purchaser, the TCRS receives an annual fee of 7.5 basis points on the \$250 million maximum issuance under this agreement. In the unlikely event that the TCRS would be called upon to purchase the notes, the TCRS would receive interest at a rate equal to prime plus 75 basis points. Moody's Investors Services, Inc. and Standard and Poor's have given these notes of the Funding Board ratings of M1G1/VM1G1 and SP-1+/A-1+, respectively.
- 2. Year 2000 Compliance**—The TCRS is currently addressing the "Year 2000" (Y2K) issue relating to computer systems and other electronic equipment. The Y2K issue refers to the fact that many computer software programs use only the last two digits of a data field to refer to

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS (CONT.)**  
**JUNE 30, 1998, AND JUNE 30, 1997**

---

“year” on the assumption that the first two digits are “19”. These programs would interpret the Year 2000 as the Year 1900, the Year 2001 as 1901, etc. The issue therefore extends to computer hardware, electronics and other equipment dependent on microchip technology. In addition, some computer programs may not recognize that the Year 2000 is a leap year, resulting in incorrect date calculations. Without reprogramming, such software and equipment could affect the ability to input data into computer programs and the ability of such programs to correctly process data. Y2K affects the computer systems utilized directly by the TCRS as well as the other systems upon which the TCRS depends to fulfill its mission. The TCRS’ Y2K initiatives relating to the retirement system did not result in the commitment of significant financial resources as of June 30, 1998.

The TCRS has assessed the impact of Y2K on its computer systems and has determined that certain computer systems are mission critical, certain are critical, and certain are supportive. Mission-critical computer systems are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the TCRS from fulfilling its mission. Critical computer systems are those for which there are manual alternatives, but the TCRS would be unlikely to be able to fully or efficiently perform the functions manually because of the volume of manual activity that would be required. Supportive computer systems are those for which there are manual alternatives that could be performed if necessary.

The TCRS relies upon three major computer systems to manage the responsibilities of the retirement program. The retired payroll system generates monthly annuity payments to more than 68,000 retirees each month. The active membership system maintains the data of more than 200,000 member records. This system is utilized to record employee and employer contributions; to record service and salary credit for each member; to process lump sum refunds to terminating members; to maintain records of each employer participating in the retirement plan; to maintain member data including beneficiary, date of birth, etc.; to provide annual statements to members; to invoice members for the purchase of service credit; and to provide benefit estimates. The third major system is the investment system which maintains a perpetual inventory of all the securities owned by TCRS. The investment system maintains a record of all the acquisitions, dispositions, and maturity of securities in the TCRS portfolio.

Other important but less significant systems include the document inventory system and the general ledger accounting system. The document inventory system is utilized to maintain a record of the incoming and outgoing documents and correspondence. The general ledger accounting system is utilized to reconcile the subsidiary ledgers and to produce financial statements.

TCRS has identified the above-mentioned computer systems that are mission critical and is subjecting those systems to the following stages of work to address Year 2000 issues.

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS (CONT.)**  
**JUNE 30, 1998, AND JUNE 30, 1997**

---

**Awareness stage**—Establishing a budget and project plan for dealing with the Year 2000 issue.

**Assessment stage**—Identifying the systems and components for which the Year 2000 compliant work is needed.

**Remediation stage**—Making changes to systems and equipment.

**Validation/testing stage**—Validating and testing the changes that were made during the remediation stage.

TCRS' Year 2000 remediation work for its mission-critical systems and electronic equipment are in the following stages of work. "C" means complete, "P" means in progress, "A" means still need to be addressed.

	<b>Awareness</b>	<b>Assessment</b>	<b>Remediation</b>	<b>Validation/Testing</b>
Retired Payroll System	C	C	P	P
Active Membership System	C	C	P	P
Investment System	C	C	C	P
Document Inventory System	C	C	P	A
Accounting System	C	C	P	P
Electronic Equipment	C	C	P	P

The TCRS has contacted external organizations with a mission-critical relationship whose Year 2000 compliance could affect the operations of the retirement system. Such organizations have responded that they are Year 2000 compliant or expect to achieve compliance prior to January 1, 2000. Other organizations with less critical relationships have been contacted to remind them of the potential problems surrounding Year 2000 and the need to evaluate their systems.

Because of the unprecedented nature of the Year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. Management cannot ensure that TCRS is or will be Year 2000 ready, that the TCRS' remediation efforts will be successful in whole or in part, or that parties with whom TCRS does business will be Year 2000 ready.

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM  
REQUIRED SUPPLEMENTARY INFORMATION  
SCHEDULE OF FUNDING PROGRESS**

---

**Exhibit C**

**SETHEEPP**

For budgetary purposes, the cost of funding the pension obligations of the state employees, teachers and higher education employees pension plan (SETHEEPP) is determined separately as follows:

- (1) General state employees and higher education employees
- (2) Teachers (grades K-12)
- (3) State Judges employed after June 30, 1972
- (4) Attorneys General employed after June 30, 1972
- (5) State Judges and Attorneys General employed prior to July 1, 1972
- (6) County Officials employed prior to July 1, 1972

All the groups above, except the County Officials group and the State Judges and Attorneys General group employed prior to July 1, 1972, are funded under the aggregate actuarial cost method. The frozen entry age actuarial method is utilized for these two groups not under the aggregate actuarial cost method. The aggregate actuarial cost method does not identify or separately amortize unfunded actuarial liabilities. The SETHEEPP groups funded under the aggregate method would not have an unfunded actuarial liability under the frozen entry age actuarial method.

In accordance with GASB 25, a schedule of funding progress is not presented since more than 98% of the liabilities are determined under the aggregate actuarial funding method.

**PSPP**

The political subdivision pension plan (PSPP) represents 365 participating entities at June 30, 1997, some of which are funded under the aggregate actuarial cost method and others under the frozen entry age actuarial method. The following data represents only those political subdivisions where the frozen entry age actuarial method is utilized.

*Expressed in Thousands*

Actuarial Valuation Date	Actuarial Value of Plan Assets (a)	Actuarial Accrued Liability (AAL) Frozen Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
6/30/97	\$1,020,240	\$1,078,231	\$57,991	94.62%	\$583,294	9.94%

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**REQUIRED SUPPLEMENTARY INFORMATION**  
**SCHEDULE OF FUNDING PROGRESS (Cont.)**

---

There are 168 of the 365 political subdivisions in TCRS as of the June 30, 1997 actuarial valuation, with an unfunded accrued liability. Information according to the parameters for measuring pension expenditures, expense and related actuarially determined disclosure information, as required by GASB, is available beginning with the transition year.

*See accompanying Notes to Required Supplementary Information.*

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM  
REQUIRED SUPPLEMENTARY INFORMATION  
SCHEDULES OF EMPLOYER CONTRIBUTIONS**

---

**Exhibit D**

*Expressed in thousands*

Year Ended June 30	<b>SETHEEPP</b>		<b>PSPP</b>	
	Annual Required Contribution	Percentage Contributed	Annual Required Contribution	Percentage Contributed
1998	\$166,756	100%	\$64,617	101%

An actuarial valuation of the TCRS is performed every two years. The June 30, 1995, valuation determined the employer contribution rate for the year ended June 30, 1997. Therefore, the Schedule of Employer Contributions, in accordance with the parameters of GASB Statement Number 25, is not available for the year ended June 30, 1997.

*See accompanying Notes to Required Supplementary Information.*

---

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO REQUIRED SUPPLEMENTARY INFORMATION**  
**AS OF JUNE 30, 1998, AND JUNE 30, 1997**

---

The information presented in the required supplementary Schedule of Funding Progress was determined as part of the actuarial valuations as of June 30, 1997. Additional information follows.

	<b><u>SETHEPP</u></b>	<b><u>PSPP</u></b>
Valuation date	6/30/97	6/30/97
Actuarial cost method	Aggregate (1)	(2)
Amortization method	Level Dollar (3)	Level Dollar (3)
Remaining amortization period	18 years (3) Closed period (3)	(4) Closed period
Asset valuation method	5-year Moving Market Average	5-year Moving Market Average
Actuarial assumptions:		
Investment rate of return	7.5%	7.5%
Projected salary increases	5.5%	5.5%
Includes inflation at	(5)	(5)
Cost-of-living adjustments	3%	3%
Increase in Social Security wage base	4.5%	4.5%

- (1) The frozen entry age actuarial method is utilized for two small closed groups: county officials employed prior to July 1, 1972, and a group of state judges and attorneys general employed prior to July 1, 1972.
- (2) Some political subdivisions are funded under the aggregate actuarial funding method and some under the frozen entry age actuarial method.
- (3) Applies to groups funded under the frozen entry age actuarial method.
- (4) The length of the amortization period varies by political subdivision but does not exceed 20 years.
- (5) No explicit assumption is made regarding the portion attributable to the effect of inflation on salaries.